STATE OF CALIFORNIA

STATE BOARD OF EQUALIZATION
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June 29, 2012

Dear Interested Party:

Enclosed is the Initial Discussion Paper on Regulation 1507, *Technology Transfer Agreements*. Discussion regarding proposed amendments to Regulation 1507 is scheduled for the Board's November 13, 2012 **Business Taxes Committee** meeting.

However, before the issue is presented at the Business Taxes Committee meeting, staff would like to provide interested parties an opportunity to discuss the issue and present any suggested changes or comments. Accordingly, a meeting is scheduled in **Room 122 at 10:00am on July 17, 2012**, at the Board of Equalization; 450 N Street; Sacramento, California.

If you are unable to attend the meeting but would like to provide input for discussion, please send your submission to the above address or send a fax to (916) 322-4530 before the July 17, 2012 meeting. Please feel free to publish this information on your website or otherwise distribute it to your associates, members, or other persons that may be interested in attending the meeting or presenting their comments.

If you plan to attend the meeting on July 17, 2012, or would like to participate via teleconference, please let staff know by contacting Mr. Robert Wilke at (916) 445-2137 or Robert.Wilke@boe.ca.gov prior to July 13, 2012. This will allow staff to make alternative arrangements should the expected attendance exceed the maximum capacity of Room 122 and to arrange for teleconferencing.

Whether or not you are able to attend the above interested parties' meeting, please keep in mind that the due date for interested parties to provide written responses to staff's analysis is **August 1, 2012**. Please be aware that a copy of the material you submit may be provided to other interested parties. Therefore, please ensure your comments do not contain confidential information.

Thank you for your consideration. I look forward to your comments and suggestions. Should you have any questions, please feel free to contact Ms. Leila Hellmuth, Supervisor, Business Taxes Committee Team, at (916) 322-5271.

Sincerely,

Susanne Buehler

Susanne Buehler, Chief
Tax Policy Division
Sales and Use Tax Department

SB: rsw

Enclosures

cc: (all with enclosures)
Honorable Jerome E. Horton, Chairman, Fourth District
Honorable Michelle Steel, Vice Chair, Third District
Honorable Betty T. Yee, Member, First District (MIC 71)
Senator George Runner (Ret.), Member, Second District (MIC 78)
Honorable John Chiang, State Controller, c/o Ms. Marcy Jo Mandel

(via email)
Mr. Robert Thomas, Board Member's Office, Fourth District
Mr. Neil Shah, Board Member's Office, Third District
Mr. Tim Treichelt, Board Member's Office, Third District
Mr. Alan LoFaso, Board Member's Office, First District
Ms. Mengjun He, Board Member's Office, First District
Mr. James Kuhl, Board Member's Office, Second District
Mr. Lee Williams, Board Member's Office, Second District
Ms. Natasha Ralston Ratcliff, State Controller's Office
Ms. Kristine Cazadd
Mr. Randy Ferris
Mr. Jeffrey L. McGuire
Mr. Jeff Vest
Mr. David Levine
Ms. Christine Bisauta
Mr. Bradley Heller
Mr. Robert Tucker
Mr. Todd Gilman
Ms. Laureen Simpson
Mr. Robert Ingenito Jr.
Mr. Bill Benson
Mr. Stephen Rudd
Mr. Kevin Hanks
Ms. Kirsten Stark
Ms. Leila Hellmuth
Mr. Robert Wilke
Ms. Lynn Whitaker

INITIAL DISCUSSION PAPER

Regulation 1507, Technology Transfer Agreements

ISSUE PRESENTED

Whether the State Board of Equalization (Board) should amend Regulation 1507, *Technology Transfer Agreements*, to clarify how the technology-transfer agreement statutes (Rev. & Tax. Code, §§ 6011, subd. (c)(10), and 6012, subd. (c)(10)) (TTA statutes) apply to transfers of computer programs on tangible storage media?

BACKGROUND INFORMATION ON THE TTA STATUTES AND REGULATION 1507

Revenue and Taxation Code (RTC) section 6006, subdivision (a), provides that a "sale" includes "any transfer of title or possession, exchange, or barter, conditional or otherwise, in any manner or by any means whatsoever, of tangible personal property for a consideration." RTC section 6009 provides that "'Use' includes the exercise of any right or power over tangible personal property incident to the ownership of that property, and also includes the possession of, or the exercise of any right or power over, tangible personal property by a lessee under a lease, except that it does not include the sale of that property in the regular course of business."

RTC section 6016 provides that "tangible personal property" is "personal property which may be seen, weighed, measured, felt, or touched, or which is in any other manner perceptible to the senses."

RTC section 6051 imposes a sales tax on retailers for the privilege of selling tangible personal property at retail. The tax is measured by gross receipts from the retail sale of tangible personal property in California. RTC section 6012, subdivision (a) provides that: "'Gross receipts' mean the total amount of the sale or lease or rental price, as the case may be, of the retail sales of retailers, valued in money, whether received in money or otherwise, without any deduction on account of . . . [t]he cost of the property sold" or any other expenses.

When sales tax does not apply, RTC section 6201 imposes a use tax on the sales price of tangible personal property purchased from a retailer for storage, use, or other consumption in California. RTC section 6011, subdivision (a) provides that "'Sales' price means the total amount for which tangible personal property is sold or leased or rented, as the case may be, valued in money, whether paid in money or otherwise, without any deduction on account of . . . [t]he cost of the property sold" or any other expenses. Accordingly, sales and use tax does not apply to transactions that do not involve tangible personal property.

1. Transfer of Intangible and Tangible Personal Property in General

The California Supreme Court has explained how tax generally applies to transactions involving the transfer of intangible property along with tangible personal property in *Simplicity Pattern Co. v. State Bd. of Equalization* (1980) 27 Cal.3d 900 (hereafter *Simplicity Pattern*), *Navistar International Transp. Corp. v. State Bd. of Equalization* (1994) 8 Cal.4th 868 (hereafter *Navistar*), and *Preston v. State Bd. of Equalization* (2001) 25 Cal.4th 197 (hereafter *Preston*). In particular, the *Preston* court examined the history of how the California Supreme Court and Courts of Appeal treated mixed transactions prior to and immediately after the enactment of the

TTA statutes. The Supreme Court found that the "decisions [prior to *Navistar*] establish that any transfer of tangible property *physically useful* in the manufacturing process is subject to sales tax even though the true object of the transfer is an intangible property right like a copyright." (*Preston* at p. 211 [citing *Simplicity Pattern*] (italics in original).) The court found that *Navistar* "held that 'physical usefulness' was not 'a necessary condition to taxation.'" (*Id*. at p. 211 [quoting from *Navistar*].) The court also held that "[a]fter *Navistar*, transfers of tangible personal property remain taxable even if [the] transfers are merely incidental to transfers of intangible property rights." (*Id.* at p. 211.)

2. Computer Programs

The Board initially adopted Regulation 1502, *Computers, Programs, and Data Processing*, in 1972 to prescribe the application of the Sales and Use Tax Law to data processing and computer programming services. However, there was still confusion over whether tax applied to the sale or lease of "custom" computer programs transferred on tangible storage media after Regulation 1502's implementation.

As a result, the Legislature enacted RTC section 6010.9 in 1982 to specifically address the application of the Sales and Use Tax Law to sales and purchases of computer programs on tangible storage media in a manner that provides "state incentives for the development and utilization of computer software." (Stats. 1982, ch. 1274, §§ 1, 2.) Under RTC section 6010.9, charges for "the design, development, writing, translation, fabrication, lease, or transfer for a consideration of title or possession, of a custom computer program" and "separately stated charges for [custom] modifications to an existing prewritten program which are prepared to the special order of the customer" are not subject to sales or use tax, even if the custom computer programs or custom modifications are transferred on tangible storage media. (RTC § 6010.9, first sentence and subd. (d), respectively.) However, charges for "a 'canned' or prewritten computer program which is held or existing for general or repeated sale or lease," did not receive special treatment, "even if the prewritten or 'canned program' was initially developed on a custom basis or for in-house use." (RTC § 6010.9, subd. (d).)

Following the enactment of RTC section 6010.9, the Board amended Regulation 1502, subdivision (f) in 1988 to address the application of tax to charges for custom computer programs, custom modifications to prewritten computer programs, and canned or prewritten computer programs in conformity with RTC section 6010.9. Also in 1988, the First District Court of Appeal interpreted RTC section 6010.9 in *Touche Ross & Co. v. State Bd. of Equalization* (1988) 203 Cal.App.3d 1057 (hereafter *Touche Ross*), which involved the taxable sale of a business that included a library of used customized and internally developed computer programs embodied on computer storage media. The court held that section 6010.9 was declaratory of, rather than a change, in existing law. (*Id.* at p. 1062.) Further, the court went on to hold that, once the program had been created and was in the possession of the original customer, the design or development service had been completed, and the program itself was a tangible personal asset to the customer. Therefore, a subsequent sale of that program by the initial customer could no longer be characterized as a "service" transaction, but rather would constitute a transfer of tangible personal property. Thus, the court concluded that the subsequent sale of such computer programs was subject to sales tax under the general provisions of RTC section 6051. (*Id.* at p. 1064.)

3. The Enactment of the TTA Statutes

On June 4, 1992, the Board adopted a memorandum opinion deciding the *Petition for Redetermination of Intel Corporation* (*Intel*) regarding two agreements (or contracts) involving transfers of intellectual property. Under the first contract, Intel transferred a license to use a patented process for producing integrated circuits, along with written information, instructions, schematics, database tapes, and test tapes, at least some of which contained copyrighted material, to the purchaser for a single, lump-sum amount. Under the second contract, Intel transferred a license to produce an integrated circuit it had designed, a license to use a patented process for producing the integrated circuit, and copies of the existing proprietary written information, instructions, schematics, database tapes, and test tapes, at least some of which contained copyrighted material, to the purchaser for a single, lump-sum amount. The Board concluded that both contracts provided for two transfers for sales and use tax purposes: a taxable transfer of tangible personal property consisting of engineering notes, manuals, schematics, database tapes, drawings, and test tapes, and a nontaxable sale of intangible property consisting of the licenses to use copyrighted or patented information. The Board further concluded that, "in the absence of a contract price for the tangible elements, the tax applies only to the value attributable to the tangible elements including the cost of manufacturing the specific tangible properties. This includes material costs, fabrication labor, and a suitable markup for overhead and profit." In addition, the Board found that a suitable markup "was 100% of the cost of materials and labor."

The TTA statutes were enacted in 1993, a year after the Board's *Intel* memorandum opinion. (Stats. 1993, ch. 887 (Assem. Bill No. 103 (1993-94 Reg. Sess.)).) Both provisions define a TTA as "**any agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest.**" (Rev. & Tax. Code, §§ 6011, subd. (c)(10)(D) and 6012, subd. (c)(10)(D), bold added.) The TTA statutes further provide that "sales price" and "gross receipts" do not include the "amount charged for intangible personal property transferred with tangible personal property in any" TTA, if the TTA "separately states a reasonable price for the tangible personal property." If there is no reasonable separately stated price, the TTA statutes prescribe a method for determining the gross receipts from, or the sales price for, tangible personal property transferred under a TTA by looking to the "price at which the tangible personal property was sold, leased, or offered to third parties." And, in the absence of previous sales, the TTA statutes provide that the taxable measure is equal to "200 percent of the cost of materials and labor used to produce the tangible personal property." (*Id.* subd. (c)(10)(A)-(C).)

4. The California Supreme Court's Post-TTA Statutes Cases

The California Supreme Court has distinguished between and applied different tests to determine whether tax applies to the transfer of intangible property together with tangible personal property and transfers of tangible personal property together with the provision of services. In *Navistar*, the manufacturer Navistar sought a tax refund on sales taxes assessed by the Board on its drawings and designs, manuals and procedures, and computer programs included in a sale of business assets. On the issue of the transfer of the design documents and manuals, the California Supreme Court rejected the "true object" test and applied the "physically useful" test found in *Simplicity Pattern* to determine whether the design documents and manuals were taxable. The Court limited the "true object" test to the transfer of tangible personal property incidental to the performance of services. (*Navistar*, *supra*, at pp. 876-877.) The Court then went on to find that Navistar's sale of the documents was neither incidental to the performance of a service, nor was there a separate and distinct transfer of an intangible property right. (*Id*. at pp. 877-878.) "A copyright is an intangible right that includes the exclusive right to reproduce, publish, and sell the literary work that is the subject of the copyright. (17 U.S.C. § 106.) **The copyright is separate and distinct from the material object embodying the work. (*Id*., § 202.)"** (*Id*. at p. 877, bold added.) In interpreting the "physical usefulness" test, the Court held that, for items valued in part for their intellectual property, physical usefulness in a manufacturing process is not a prerequisite to the imposition of the sales tax. (*Id.* at p. 878.) The Court found that "the documents involved here must be characterized as tangible personal property for purposes of tax law, thus rendering their sale taxable." (*Id.* at p. 880.) Because the case did not involve copyrights and patents, the TTA statutes did not apply. (*Ibid.*)

Regarding the transfer of computer programs, Navistar contended that because the computer programs were custom-developed in-house for its own business use, rather than for general or repeated sales, they were custom computer programs and therefore not taxable. (*Navistar*, *supra*, at p. 880.) The Court, however, relying on the rationale in *Touche Ross*, held that Navistar's transfer of computer programs was taxable because at the time of their sale, the service performed in developing the programs for Navistar had been completed. Thus, when the sale occurred, the computer programs no longer constituted specially ordered custom programs as defined in RTC section 6010.9. (*Id.* at p. 883.)

In *Preston*, the California Supreme Court discussed the meaning of the TTA statutes before applying them to a number of written agreements transferring the right to reproduce copyrighted artwork (i.e., illustrations and designs) in children's books and on rubber stamps to two book publishers and a rubber stamp manufacturer, respectively. The Court stated that: "Read as a whole and giving the statutory language its ordinary meaning, *sections 6011(c)(10)* and *6012(c)(10)* unambiguously establish that the value of a patent or copyright interest transferred pursuant to a technology transfer agreement is *not* subject to sales tax even if the agreement also transfers tangible personal property. . . . In other words, these provisions exclude the value of a patent or copyright interest from taxation whenever a person who owns a patent or copyright transfers that patent or copyright to another person so the latter person can make and sell a product embodying that patent or copyright." (*Preston*, *supra*, at pp. 213-214, italics in original.)

The Court also found that the agreements transferring the rights to reproduce copyrighted artwork in children's books and on rubber stamps constituted TTAs because they transferred the right to make and sell products that were subject to the transferor's copyrights. (*Id.* at p. 215.)

Further, and as relevant here, the Court explained the fundamental attributes of transfers involving copyrights and patents. The Court stated:

> Patents give an owner "the exclusive right to manufacture, use, and sell his invention." [Citation omitted.] Thus, **the license of a patent interest, by definition, gives the licensee the right to make a product or to use a process**. In contrast, "copyright protects originality rather than novelty or invention–conferring only 'the sole right of multiplying copies.'" (*Mazer* [*v. Stein* (1954)] 347 U.S. [201], 218, 74 S.Ct. 460, fn. omitted.) Thus, **the license of a copyright interest can only give the licensee the right to reproduce the copyrighted material in a product–and not the right to make and sell a product**. Because *sections 6011(c)(10)* and *6012(c)(10)* expressly exempt the assignment or license of the right to make and sell a product subject to *either* a patent *or* copyright from taxation, they must encompass agreements, like Preston's, that **license the right to reproduce copyrighted material in a product to be manufactured and sold by the licensee**. (*Preston*, *supra*, at pp. 215-216, italics in original, bold added.)

The Court then went on to specifically distinguish the portion of the sales agreement at issue in *Navistar* from the sales agreements at issue in *Preston*. It explained that *Navistar* did not involve the transfer of separate and distinct intangible property rights, but *Preston* did involve "the separate and distinct transfer of a copyright--an intangible right distinct from 'any material object in which the work is embodied,'" that is the right to produce and sell products embodying the copyrighted work. Accordingly, the Court decided that the TTA statutes applied in *Preston*. (*Preston*, *supra*, at p. 220.)

5. Regulation 1507

Regulation 1507 was originally adopted in 2002 to implement the TTA statutes and incorporate the California Supreme Court's holding in *Preston*. However, Regulation 1507 does not address the general application of the Sales and Use Tax Law to transfers of intangible property, such as copyrights and patents. Instead, Regulation 1507 defines TTAs and explains the application of tax to transactions involving TTAs.

Regulation 1507, subdivision (a)(1) currently provides that:

> "Technology transfer agreement" means an agreement evidenced by a writing (e.g., invoice, purchase order, contract, etc.) that assigns or licenses a copyright interest in tangible personal property for the purpose of reproducing and selling other property subject to the copyright interest. A technology transfer agreement also means a written agreement that assigns or licenses a patent interest for the

> right to manufacture and sell property subject to the patent interest, or a written agreement that assigns or licenses the right to use a process subject to a patent interest.
>
> A technology transfer agreement does not mean an agreement for the transfer of any tangible personal property manufactured pursuant to a technology transfer agreement, nor an agreement for the transfer of any property derived, created, manufactured, or otherwise processed by property manufactured pursuant to [a] technology transfer agreement.

Regulation 1507, subdivision (a)(1) and (3), explains that, under the TTA provisions, tax will not apply to charges for the right to use a patented process that is external to tangible personal property, but that tax will apply to all of the charges for the transfer of tangible personal property, including charges for the use of tangible personal property that performs a process related to "patented technology embedded in the internal design, assembly or operation of the" tangible personal property. (Regulation 1507, subd. (a)(1), example 3, and (a)(3).)

Regulation 1507, subdivision (a)(2) through (4), implements, interprets, and makes specific the terms "process," "assign or license," "copyright interest," and "patent interest" from the TTA statutes. As relevant here, the regulation defines "process" to mean: "one or more acts or steps that produce a concrete, tangible and useful result that is patented by the United States Patent and Trademark Office, such as the means of manufacturing tangible personal property. Process may include a patented process performed with an item of tangible personal property, but *does not mean or include the mere use of tangible personal property subject to a patent interest.*" (Regulation 1507, subd. (a)(3), italics added.) In addition, the regulation provides that "'Assign or license' means to transfer in writing a patent or copyright interest to a person who is not the original holder of the patent or copyright interest where, absent the assignment or license, the assignee or licensee would be prohibited from making *any use* of the copyright or patent provided in the technology transfer agreement." (Regulation 1507, subd. (a)(4), italics added.)

6. The Court of Appeal's TTA Case

Subdivision (a) of Regulation 1507 originally provided that "A technology transfer agreement also does not mean an agreement for the transfer of prewritten software as defined in subdivision (b) of Regulation 1502." On January 18, 2011, however, the provision was invalidated by the Second District Court of Appeal in *Nortel Networks, Inc. v. Board of Equalization* (2011) 191 Cal.App.4th 1259, 1278 (hereafter *Nortel*).

The Court of Appeal noted that the factual basis for its *Nortel* decision was uniquely limited. Footnote 2 to the entire statement of facts explains that "[o]wing to state budgetary problems, the sole expert witness designated by the state refused to be deposed because his fee was unpaid. As a result, he was not permitted to testify at trial, a lapse the trial court aptly forecast as 'fatal' to the state's defense. Nortel was the beneficiary of the state's fiscal distress: to make its factual findings, the trial court had to rely exclusively on technical testimony from a procession of

Nortel-friendly witnesses. The court found the testimony ‘credible in all respects,’ based on the witnesses’ candor and demeanor.” (*Nortel*, *supra*, at p. 1265, fn. 2).

Based upon the limited factual record, and stipulated facts, the court found that “Nortel and Pacific Bell entered [into] licensing agreements giving Pacific Bell the right to use Nortel's software programs in the switches” Pacific Bell purchased from Nortel. (*Nortel*, *supra*, at p. 1265.) The licensing agreements concerned “two types of licensed software . . . [: (A)] prewritten operator workstation programs (that connect customers to operators), data center programs (that connect customers to directory assistance), and switch-connection programs (that allow switches to communicate)”; and (B) “switch-specific programs (SSP’s) that operate the switch and enable it to process telephone calls.” (*Ibid*.) “The three prewritten programs licensed by Nortel are copyrighted . . . [and] subject to Nortel’s patents.” (*Id*. at p. 1278.) “Each SSP is unique, is created for a particular switch, and cannot be used to operate any other switch”; and “[o]wing to their uniqueness, SSP’s are ‘never’ offered for general sale, or for repeated sale or lease.” (*Id*. at p. 1265.) Also, “Nortel copyrights its SSP’s: each program is ‘an original work of authorship created by the Nortel software programmers’” and the “SSP itself incorporates one or more processes that are subject to—and implement—Nortel’s patent interests.” (*Id*. at p. 1266.)

The court further found that the “completed SSPs [are] shipped to Pacific Bell on disks, magnetic tapes, or cartridges, also known as ‘storage media,’” and that “Nortel provides Pacific Bell with the three prewritten programs.” (*Nortel*, *supra*, at p. 1267.) “The licensing agreements allow Pacific Bell to copy the software from the storage media and load it into the operating memory of a switch's computer hardware. This authorization to copy the software onto its computers allows Pacific Bell to use the programs without violating Nortel’s copyright.” (*Id*. at p. 1268.) And, “[t]he license gives Pacific Bell the right to produce telephonic communications, without fear of infringing upon Nortel’s patents.” (*Ibid*.) Furthermore, “Pacific Bell used the patented processes contained in the SSPs to create and sell a product; namely, telephone communications for consumers,” including “basic and long distance telephone calls; call forwarding; caller identification; call waiting; conference calling; music-on-hold; and voice mail.” (*Id*. at p. 1274.)

Therefore, based upon the above findings and the parties’ stipulations, the court found that SSPs are unique computer programs that are not subject to the provisions of RTC section 6010.9 because they are neither custom nor prewritten. (*Nortel*, *supra*, at pp. 1270-1273.) The court held that “Nortel licensed the right to copy the diskette containing the SSP onto Pacific Bell’s switch, making this a valid license of a copyrighted interest under the TTA statutes” (*id*. at p. 1275); that Nortel also licensed the right to copy the prewritten programs onto Pacific Bell’s switch and that the “prewritten programs are TTAs” (*id*. at p. 1278); that Nortel licensed the right to make and sell products subject to Nortel’s patent interests to Pacific Bell (the right to make and sell phone calls) within the meaning of the TTA statutes (*id*. at pp. 1273-1274); and that Nortel also “licensed the right to use [the SSPs to perform] patented ‘processes’ within the meaning of the TTA statutes” (*id*. at p. 1275).

Since the Board and Nortel stipulated to the amount of "cost of materials and labor" of the storage media upon which the SSPs and prewritten computer programs were transferred to

Pacific Bell, and the Board never actually litigated the issue of what constituted the tangible personal property in the transactions and what the cost of the storage media should include, the court limited the measure of tax to the stipulated "cost of producing the storage media." (*Nortel, supra*, at p. 1268.)

In *Nortel*, the court also addressed the Board's amendment of the definition of computer "program" in Regulation 1502 during the course of the litigation. However, the court appeared to either disregard or give little weight to the amended definition. (*Nortel, supra,* at pp. 1272-1273.)

7. Franchise Income Tax Case

On February 17, 2011, the Superior Court of San Francisco County issued a decision in *Microsoft Corporation v. Franchise Tax Board* (Case No. CGC-08-471260) (hereafter *Microsoft*). In the decision of this income tax case, which was appealed to the First District Court of Appeal on May 12, 2011 (Case No. A131964), the court determined that computer programs, themselves, are tangible personal property for income tax purposes when they are embodied on tangible storage media. In making this conclusion, the court relied heavily on Sales and Use Tax Law cases and analyses of sister states' Supreme Courts. The court stated in its decision that:

- "Tangible personal property is defined as '[c]orporeal personal property of any kind; personal property that can be seen, weighed, measured, felt, or touched, or is in any other way perceptible to the senses, such as furniture, cooking utensils, and books'" (quoting from Black's Law Dict. (9th Ed. 2009) pp. 1337-1338);
- "[S]tate courts from a number of jurisdictions have determined that computer software constitutes tangible personal property, in that it 'is knowledge recorded in a physical form which has physical existence, takes up space on the tape, disc, or hard drive, makes physical things happen, and can be perceived by the senses" (quoting from *South Central Bell Telephone Co. v. Barthelemy* (La. 1994) 643 So.2d 1240, 1246-1247, and also citing *Andrew Jergens Company v. Wilkins* (Ohio 2006) 848 N.E.2d 499, 502-503; *South Central Utah Telephone Association v. Utah State Tax Commission* (Utah 1997) 951 P.2d 218, 223-224; *Wal-Mart Stores, Inc. v. City of Mobile* (Ala. 1996) 696 S.2d 290, 291; *Hasbro Industries, Inc. v. Norberg* (R.I. 1985) 487 A.2d 124, 128);
- "The software itself, i.e., the physical copy, is not merely a right or an idea to be comprehended by the understanding. The purchaser of computer software neither desires nor receives mere knowledge, but rather receives a certain arrangement of matter that will make his or her computer perform a desired function. This arrangement of matter, physically recorded on some tangible medium, constitutes a corporeal body" (*South Cent. Bell Tel. Co. v. Barthelemy, supra,* at p. 1246);
- Thus, computer software is "corporeal in nature, in that it 'is stored on a computer's hardware, takes up space on the hard drive and can be physically perceived by checking the computer's files. It remains in the computer and operates the program each time it is

used'" (quoting from *Graham Packaging Co., LP v. Commonwealth* (Pa. Cmwlth. 2005) 882 A.2d 1076, 1086-1087, and also citing *Dechert v. Commonwealth of Pennsylvania* (Pa. Cmwlth. 2007) 942 A.2d 210, 212. and *Dechert v. Commonwealth of Pennsylvania* (Pa. Cmwlth. 2007) 942 A.2d 87, 90-91);

- The court's finding "is consistent with the manner in which software that is prewritten, or 'canned,' as opposed to customized, is treated by California for sales and use tax purposes" (citing and discussing *Navistar*, *supra*, at pp. 880-881 and *Touche Ross*, *supra*, at p. 1064); and
- The court's view "is consistent with the universal practice by states of treating canned software as tangible personal property for sales and use tax" purposes (citing Hellerstein & Hellerstein, State Taxation (3d ed. 2000) ¶ 13.06[3] [a]).

8. 2011 Amendments to Regulation 1507

On May 25, 2011, the Board voted to repeal the sentence in Regulation 1507 regarding prewritten software, which the Second District Court of Appeal invalidated in *Nortel*, pursuant to California Code of Regulations, title 1, section 100.

9. Press Release

On May 27, 2011, the Board issued a press release regarding *Nortel*, which provided that:

> Jerome Horton, Chairman of the State Board of Equalization, today announced that the Board authorized an amendment to make its current regulations consistent with a recent California Court of Appeal decision holding that sales tax does not apply to interests in patents and copyrights transferred with prewritten (or canned) software in a technology transfer agreement (TTA). The Board made the clarifying regulatory change at its Sacramento meeting this week.
>
> The Board announced that the change does not affect the way sales tax is applied to the typical off-the-shelf retail sale of canned, mass-marketed software because the typical retailer does not hold any copyright or patent interests in the software. The change only clarifies that when the holder of copyrights or patents also sells that intellectual property to another in a technology transfer agreement that includes the transfer of software, the amount charged for the copyrights or patents is excluded from the application of sales tax.
>
> "The courts have spoken and the message is clear, canned software is taxable and intellectual property is not," Horton said. "With the help of the industry we will provide further guidance on how tax applies to sales of software."
>
> The California Court of Appeal in January 2011 filed an opinion in Nortel Networks, Inc. v. State Board of Equalization that expressly provides that:

> "To the extent that regulation 1507, subdivision (a)(1) excludes from the definition of a TTA prewritten computer programs that are subject to a copyright or patent, the regulation exceeds the scope of the Board's authority and does not effectuate the purpose of the TTA statutes: It is, for these reasons, invalid."
>
> On April 27, 2011, the California Supreme Court issued a notice denying the Board's Petition for Review of the Court of Appeal's opinion.

10. TTA Study

On August 23, 2011, the Board authorized staff to conduct a study to evaluate the feasibility of developing an optional percentage that can be used to reasonably estimate the fair market value of tangible personal property in technology agreements involving non-custom computer programs transferred on tangible storage media. However, the study has not proceeded because there has been a lack of industry participation thus far.

11. Pending Litigation

The Board is currently defending suits for refund in *Lucent Technologies*, *Inc. v. State Bd. of Equalization* **(**Los Angeles Superior Court Case No. BC402036) and *Lucent Technologies, Inc. II v. State Bd. of Equalization* (Los Angeles Superior Court Case No. BC448715), which raise TTA issues regarding the transfer of software programs embodied on storage media for use in conjunction with telephone switches.

DISCUSSION OF *NORTEL* AND *NORTEL*-RELATED ISSUES

Board staff is aware that some in Industry have urged staff to concede that *Nortel* establishes a broad exemption for all sales of non-custom computer programs transferred on tangible storage media because practically all computer programs are subject to copyrights and the Second District Court of Appeal cited *Preston* in holding that "[t]ransferring the right to reproduce [a] copyrighted work is a TTA." (*Nortel*, *supra*, at p. 1274.) Board staff is also aware that some in Industry have urged staff to establish a policy limiting the measure of sales and use tax in TTAs involving the transfer of non-custom computer programs encoded on tangible storage media (i.e., the disk, thumb drive, etc.) to the cost of the storage media, alone, based upon the measure of tax ultimately upheld in *Nortel*. (See, e.g., Exhibit 1, March 20, 2012, letter submitted on behalf of the California Chamber of Commerce, California Manufacturers & Technology Association, California Taxpayers Association, Council on State Taxation, Silicon Valley Leadership Group, Silicon Valley Tax Directors Group, Software Finance & Tax Executives Council, and TechAmerica.)

Due to *Nortel's* limited precedential impact, however, Board staff does not believe that such a policy is either legally justified or appropriate. Furthermore, the Board does not concede that refunds are due in the *Lucent* and *Lucent II* lawsuits. The *Nortel* decision is fact specific, and a broad reading of *Nortel* would be inconsistent with the language of the TTA statutes, the Legislature's intent in enacting the TTA statutes, the provisions of Regulation 1507, and the California Supreme Court's and Court of Appeal's holdings regarding the taxation of the transfer of tangible media upon which computer programs have been encoded in *Navistar* and *Touche Ross*. In addition, in a recent California Supreme Court case, *Dicon Fiberoptics, Inc. v. Franchise Tax Bd.* (2012) 53 Cal.4th 1227, the Court strongly emphasized that in adjudicating tax disputes, statutes granting tax exemptions must be strictly construed against the taxpayer. Thus, when the taxpayer and the tax agency each offer a reasonable interpretation of a statutory exemption, the court should resolve any doubts in favor of the tax agency.

1. Holder Requirement

The TTA statutes expressly provide that TTA "means any agreement under which a *person who holds a patent or copyright interest* assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest." (Italics added.) The California Supreme Court analyzed the holder requirement in *Preston* and found that "Preston owned the copyrights in the transferred artwork" at issue in that case. (*Preston, supra*, at p. 214.) However, due to factual stipulations made in the *Nortel* case, the court in *Nortel* did not directly address or discuss the holder requirement. Under Regulation 1507, sales of copyrighted computer programs are not TTAs when the retailers selling the programs do not hold any patent or copyright interests in the programs, based upon the express statutory definition of a TTA; therefore, the TTA statutes do not apply to such sales. Consequently, Board staff will require that taxpayers satisfy the holder requirement in order to establish that agreements for the sale or purchase of non-custom computer programs, in fact, constitute TTAs.

2. Tangible Nature of Computer Programs Encoded on Storage Media

The TTA statutes do not provide any exemption for amounts that are reasonably charged for, or allocated under Regulation 1507 to, tangible personal property transferred in TTAs. In this respect, as a general rule, charges for physical objects valued in part for their intellectual content are taxed under the sales tax as tangible personal property on their total worth. (See *Simplicity Pattern, supra,* at p. 906, citing *Michael Todd v. Los Angeles County* (1962) 57 Cal.2d 684 [assessment of movie film negatives as tangible personal property may include copyright value].)

On account of the parties' stipulations in *Nortel*, the court never adjudicated the issue of what constituted the tangible personal property in those transactions: the computer media in blank form or the computer media with the computer programs encoded on them, as actually acquired and transferred. Consequently, the *Nortel* decision has no precedential effect whatever on the tangible nature of computer programs encoded in tangible physical form on storage media. The *Nortel* court of appeal decision, therefore, does not and cannot be held to be in conflict with or overrule the Supreme Court's decisions in *Simplicity Pattern, Navistar*, and *Preston*.

3. Embedded Patented Processes

Regulation 1507, subdivision (a)(1) and (3), provides that, under the TTA provisions, tax will not apply to charges for the right to use a patented process that is external to tangible personal property, but that tax will apply to all of the charges for the transfer of tangible personal property, including charges for the use of tangible personal property that performs a process related to "patented technology embedded in the internal design, assembly or operation of the" tangible personal property. (Reg. 1507, subd. (a)(1), example 3, and (a)(3).) In *Nortel*, the Court of Appeal upheld these provisions of Regulation 1507, but found that they did not apply because "Nortel's patented processes for making telephone calls are not embedded in the internal design of the switch equipment at the time of manufacture." (*Nortel*, *supra*, at p. 1275.) Further discussion and clarification may be required, however, to fully and completely interpret and apply the term "embedded," and to distinguish a patented process that is "embedded in the internal design, assembly or operation of the tangible personal property" from a patented process that is "external to the tangible personal property."

4. Making and Selling a Product Subject to a Copyright Interest

The TTA statutes provide that the term TTA "means any agreement under which *a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product* or to use a process *that is subject to the patent or copyright interest*." (Italics added.) In *Preston*, the California Supreme Court explained that an agreement assigns or licenses the right to make and sell a product subject to a copyright if it transfers the right to reproduce a copyrighted work or to produce another product that incorporates a copy of the copyrighted work <u>and</u> to sell the copies or products. (*Preston*, *supra*, at p. 215.) The California Supreme Court also found that "Preston's Agreements gave the transferees the right to make and sell books or rubber stamps that incorporate a copy of her copyrighted artwork. Thus, the Agreements necessarily licensed the right to 'make and sell a product . . . subject to the . . . copyright interest.'" (*Ibid*.) In addition, the Court explained that an agreement assigns or licenses the right to make and sell a product subject to a patent if it transfers the right to manufacture and sell a patented invention. (*Id*. at p. 216.)

Board staff understands that the *Nortel* opinion contains some broad language that could be used by industry to argue that any transfer of the right to copy a copyrighted computer program embodied on storage media onto any computer for any reason constitutes a TTA because it allows the transferee to make a copy of a copyrighted work. (See *Nortel*, *supra*, at p. 1278.) However, that interpretation is inconsistent with the express provisions of the TTA statutes which require that a TTA involving the transfer of a copyright interest include the right to make <u>and</u> sell a product subject to the copyright interest. Furthermore, such a broad interpretation is inconsistent with the California Supreme Court's holdings in *Preston* that copyright TTAs must involve a transfer of a copyright separate and distinct from any material object in which the work is embodied, the license of a copyright interest can only give the licensee the right to reproduce the copyrighted material in a product, and copyright TTAs must include the right to make and sell products subject to copyrights. Finally, Regulation 1507, subdivision (a)(4), provides that the definition of "assign or license" means a transfer where, "absent the assignment or license, the assignee or licensee would be prohibited from making any use of the copyright or patent provided in the technology transfer agreement." Thus, before an agreement can be found to constitute a TTA, the claimant has the burden of showing that the license provides rights beyond that which would otherwise be permitted.

In addition, the *Nortel* court was not presented with and did not explain the issue of how the "products" (telephone calls and telephonic services) that Pacific Bell made and sold were themselves subject to patents or copyrights that Nortel transferred to Pacific Bell. (*Id*. at pp. 1273-1275.) Specifically, the court did not explain how these "products" were copies of or incorporated original works for which Nortel held the copyrights; what specific copyright rights were transferred from Nortel to its customers under the TTA; and what specific product was made by virtue of each respective copyright allegedly subject to the license.

5. Measure of Tax

The TTA statutes and Regulation 1507 expressly prescribe the measure of tax in a TTA. They provide that when a TTA contains a reasonable separately stated price for the tangible personal property, then that price controls the measure of tax, provided the separately stated price represents the reasonable retail fair market value of the tangible personal property. They explain that in the absence of a separately stated reasonable price in a TTA, the measure of tax may be established by the separate price at which the tangible personal property or like (similar) tangible personal property was previously sold, leased, or offered for sale or lease, to an unrelated third party. And, in the absence of such reasonable and reliable indicia of value, the measure of tax is equal to 200 percent of the combined cost of the materials and labor used to produce the tangible personal property. For this purpose, "cost of materials" consists of those materials used or otherwise physically incorporated into any tangible personal property transferred as part of a TTA, and "cost of labor" includes any charges or value of labor used to create the tangible personal property in the form transferred.

In *Nortel*, the parties had stipulated to the amount of the cost of the materials and labor used to produce the computer media at issue in that case. Consequently, the parties did not litigate, and the court did not need to address, the issue of how to compute the cost to produce storage media upon which a computer program is physically encoded. Therefore, when a TTA does not contain a reasonable separately stated sales price for tangible personal property, Board staff will adhere to the TTA statutes and regulation in determining the measure of tax for the tangible personal property based upon the separately stated price at which the same tangible personal property was previously sold, leased, or offered for sale or lease, to an unrelated third party, including sales and offers to sell by other retailers, including retailers that do not hold any patents or copyrights (non-holders). In the absence of such statutory data, the cost of the materials and labor used to produce the tangible personal property must be established by the taxpayer to meet its burden of proof.

Inasmuch as the parties in *Nortel* stipulated to the "cost of materials and labor" to produce the computer media at issue as indicated above, the *Nortel* decision provides no guidance whatsoever about how to calculate the cost of producing tangible personal property transferred in a TTA. Therefore, when necessary, Board staff will determine the measure of tax for the tangible personal property based upon 200 percent of the actual cost of the materials and labor used to produce the storage media, including the cost to develop the software encoded thereon. And, because the taxpayer has the burden of producing the cost information, if the taxpayer fails to meet its burden, Board staff will generally have no option but to presume that all of the consideration paid in a TTA is attributable to the tangible personal property.

SUMMARY

Board staff is open to discussing *Nortel* and whether the Board should amend Regulation 1507 to clarify how the TTA statutes apply to transfers of computer programs encoded onto computer storage media. Staff also is open to recommending amendments to Regulation 1507 to clarify the application of tax to TTAs if the general consensus of interested parties and staff can agree that the amendments are clarifying and consistent with all of the above-referenced authorities. Such amendments would presumably be respected by the courts. However, staff believes a general interested parties discussion is appropriate before any such amendments are specifically proposed or contemplated. Staff is also mindful that the Board Members have directed that a report regarding the scheduled interested parties meeting be made to the Business Taxes Committee before further action is taken. Finally, staff remains open to discussing with interested parties whether it may be appropriate for the Board to give consideration to the adoption of an optional percentage that can be used to reasonably estimate the retail fair market value of tangible personal property in TTAs involving non-custom computer programs transferred on computer storage media.

Prepared by the Tax Policy Division, Sales and Use Tax Department, and the Tax and Fee Programs Division, Legal Department

Current as of 06/27/12

March 20, 2012

Via Email

Ms. Susanne Buehler
Chief
Tax Policy Division
Sales and Use Tax Department
State Board of Equalization
State of California
450 N Street
Sacramento, CA 94279-0092

Re: State Board of Equalization's Memorandum, Dated November 7, 2011, Titled "Sales of Software Pursuant to Technology Transfer Agreements"

Dear Ms. Buehler:

This letter is the response of the California business community to the Memorandum dated November 7, 2011, issued by the Tax Policy Division (the "memo") purporting to provide, *inter alia*, guidance on how to interpret and apply *Nortel Networks Inc. v. Board of Equalization* (2011) 191 Cal.App.4th 1259 [119 Cal.Rptr.3d 905] ("*Nortel*") to "the sale or purchase of non-custom software on tangible storage media . . . ." (Memo, p. 2.) We request that the memo be rescinded and a new memo be issued providing guidance consistent with the TTA Statutes, *Nortel*, federal copyright and patent law and California sales and use tax law.

As is more fully set forth below, the business community does not agree with the interpretation contained in the memo because it directly conflicts with the holding in *Nortel* and is not in accordance with California sales and use tax law and federal intellectual property law. The memo sets forth an improper legal standard both for (1) identifying an agreement that is a technology transfer agreement ("TTA") within the meaning of sections 6011 (c)(10)(D) and 6012 (c)(10)(D) ("TTA provisions"),[1] and (2) valuing the tangible personal property transferred in a TTA. The memo further suggests impractical and legally unnecessary audit substantiation requirements. Also, it fails to take into account the business models and practices of the software industry. All this curtails the application of the TTA Statutes and mischaracterizes *Nortel* so as to limit its holding to only a few fact patterns. The memo demonstrates a fundamental

[1] All statutory references are to the Revenue and Taxation Code, unless otherwise indicated.

misunderstanding of the law and the way the software industry conducts business and will create confusion and uncertainty for taxpayers and tax administrators.

Under the TTA Statutes, the charge for intangible personal property (here, the right to use software that is subject to the licensor's patent and/or copyright interests) transferred with tangible personal property (here, storage media or disk) in any TTA is not subject to sales or use tax. What is subject to tax is the price of the storage media.[2]

The memo, however, disregards these principles and instructs auditors to require that taxpayers establish legally unnecessary facts and provide specific documentation not legally required. Thus, the memo should be rescinded and a new memo be issued providing guidance consistent with the TTA Statutes, *Nortel*, federal copyright and patent law and California sales and use tax law.

The business community represented by this letter includes (i) holders of patent and copyright interests who sell licenses of the right to use software enabling licensees to make and sell products or to use processes that are subject to the licensor's patent or copyright interests, and (ii) purchasers of licenses of such rights.

[2] See *Nortel*, *supra*, 191 Cal.App.4th at pp. 1267-68: "The completed SSP [switch-specific software program] is shipped to Pacific Bell on disks, magnetic tapes, or cartridges, also known as 'storage media.' . . . The cost of producing the storage media is negligible – $54,604 – and the licensing agreements do not separately state a price for the storage media;" see also *id.* at p. 1276: "Pacific Bell made little use of the tangible disk containing the program, which was simply copied onto its computers, but it made continuous use of the intangible information contained on the disk, information that was necessary to run the switch. Pacific Bell's ability to use the information contained in the SSP was an intangible personal property right."

The business community believes the analysis set forth in the memo is erroneous for the following reasons, among others:[3]

- The memo directly contradicts the TTA Statutes and *Nortel* by prescribing artificial standards for identifying TTAs and determining the amount eligible for exclusion.
- The memo imposes artificial, impractical, and unnecessary substantiation requirements as the exclusive means of proving a TTA on all taxpayers.
- The memo misinterprets the TTA Statutes and the unanimous decision in *Nortel*.

1. The Memo Contradicts the TTA Statutes and *Nortel*.

A. What the TTA Statutes and Nortel provide.

The TTA Statutes exclude from the definition of "sales price" (and thus effectively exclude from sales taxation), "[t]he amount charged for intangible personal property transferred with tangible personal property in any technology transfer agreement . . . ." (§§ 6011(c)(10)(A) and 6012(c)(10)(A).) A TTA is an "agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest." (§§ 6011(c)(10)(D) and 6012(c)(10)(D).)

Computer software is subject to copyright protection. (See *Nortel*, *supra*, 191 Cal.App.4th at pp. 1273-1277.) Copyright protection extends to computer programs. (*Id*. at p. 1273.) "Copyright in a work created on or after January 1, 1978, subsists from its creation . . . ." (17 U.S.C. § 302(a).) Copyright protection exists as soon as the subject matter is fixed in any tangible medium of expression. (*Id*. § 102(a).) "The series of sequences and steps (e.g., process) carried out by computer software [is] expressed in a form that is considered to be a literary work that is subject to copyright protection." (*Nortel*, *supra*, 191 Cal.App.4th at p. 1273.)

Computer software is subject to patent protection. Processes embodied and implemented by software can be subject to patent interests. (See *Nortel*, *supra*, 191 Cal.App.4th at pp. 1273-1277.) Thus, the software itself can be subject to patent interests. But for the license to use such software, users would be infringing on the holder's patented processes. (35 U.S.C. § 271(a) ["Except as otherwise provided in this title . . . , ***whoever without authority*** makes,

[3] The memo, at page 2, states that the court in *Nortel* "found the provisions of Regulation 1507 regarding patented processes in the internal design, assembly, or operation of tangible personal property did not apply to the software at issue in the case." Our understanding is the parties in *Nortel* stipulated the software was not "embedded" software. As such, the court made no finding whatsoever regarding the application of Regulation 1507 to embedded software; embedded software simply was not at issue in the case. If a transaction involving embedded software otherwise meets the requirements of the TTA provisions, the amount charged for the intangible software is excluded from taxation.

uses, offers to sell, or sells ***any patented invention***, within the United States or imports into the United States any patented invention during the term of the patent therefor, ***infringes the patent***."] Bold and italics added.) Thus, when software is transferred along with tangible personal property (*i.e.*, storage media) pursuant to a TTA, the charge for intangible personal property (*i.e*., the right to use software that is subject to the assignor's or licensor's patent and/or copyright interests) is not subject to sales or use tax. Only the amount charged for any tangible storage media is subject to tax. (*Nortel*, *supra*, 191 Cal.App.4th at pp. 1267-68).

B. The memo oversimplifies the TTA Statutes and Nortel.

The memo includes the following sentence: *Nortel* "applies to sales of software on tangible storage media together ***with an assignment or license of certain patent or copyright interests*** applicable to the software." (Memo at p. 2, emphasis added.) This sentence oversimplifies and is not in accordance with the plain language of the TTA Statutes or *Nortel*.

For an agreement to be a TTA, sections 6011(c)(10)(D) and 6012(c)(10)(D) only require that the agreement be an "agreement under which a person who holds a patent or copyright interest assigns or licenses to another person the right to make and sell a product or to use a process that is subject to the patent or copyright interest."

The memo's abbreviated paraphrase of this statutory language omits significant aspects relevant to an audit. "The TTA statutes cover agreements licensing 'the right to make and sell a product *or* to use a process that is subject to the patent or copyright interest.'" (*Nortel*, *supra*, 191 Cal.App.4th at p. 1275, italics in original.) Thus, with respect to the "process" component of sections 6011(c)(10)(D) and 6012(c)(10)(D), the component at issue in the memo and discussed in this letter, the only requirement is that the "process" be subject to a copyright or patent interest of the assignor or licensor. *Nortel* affirmed this construction of the TTA Statutes when it noted "[a]n agreement is a TTA if . . . the holder of a patent assigns or licenses '***a process***' that is subject to the patent." (*Nortel*, *supra*, 191 Cal.App.4th at p. 1273, bold and italics added. See also *id.* at p. 1265.). There is no requirement that there be any license or assignment of a copyright or patent interest; all that is required is the presence of a license or assignment of a right to use a process that is subject to a copyright or patent interest.

C. The memo improperly classifies software as tangible personal property.

The memo states at page 4 that "[s]oftware transferred on tangible storage media is tangible personal property, whether in source code or object code form, together with the storage media upon which the software has been imprinted or encoded." The fundamental premise of this statement is erroneous and finds no basis in the law after the enactment of the TTA Statutes and *Nortel*. Software remains intangible personal property regardless of the method or manner used to transfer it to a customer. [4]

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[4] *Nortel*, *supra*, 191 Cal.App.4th at p. 1276: "Pacific Bell made little use of the tangible disk containing the program, which was simply copied onto its computers, but it made continuous use of the ***intangible information contained on the disk***, information that was necessary to run the

(continued...)

Moreover, the ***right*** to use software is another form of intangible personal property. Software is a sequence of data processing instructions that allow a computer to solve a problem. (See *Nortel*, *supra*, 191 Cal.App.4th at p. 1271.) The "right" to use the sequence is "intangible personal property." (*Id*. *at* p. 1269. See *Preston v. State Bd. of Equalization* (2001) 25 Cal.4th 197, 208 [105 Cal.Rptr.2d 407, 19 P.3d 1148] ("Although there is no statutory definition of intangible property, 'such property is generally defined as property that is a "right" rather than a physical object.'").) "Intellectual property is an intangible right 'existing separately from the physical medium that embodies it.'" (*Nortel*, *supra*, 191 Cal.App.4th at p. 1269.)

In *Nortel*, the court identified the storage media as tangible and identified the software and the right to use the software transferred on such storage media as intangible.[5] Thus, there is no basis in law for the memo to conclude that software is tangible personal property, much less when the charge is for licensing the ***right to use*** such software transferred with storage media in a TTA, which, too, is intangible personal property."

D. The memo ignores how software is licensed in real business settings and advances an erroneous method for determining the amount eligible for exclusion under the TTA Statutes.

The approach set forth in the memo for determining the amount eligible for exclusion under the TTA Statutes misapplies *Nortel* and the plain language of the TTA Statutes and presents a hypothetical example whose assumed facts are an artificial situation that never occurs in real-world business settings. The TTA Statutes and *Nortel* set forth a residual approach for determining the amount eligible for exclusion whereby the price paid for tangible storage media is subtracted from the sales price or gross receipts, and the difference is the excludible amount paid for the transfer of intangible personal property (*i.e.*, software or the right to use software).

Section 2(b) on page 4 of the memo contains the following hypothetical:

> This would include the separately stated retail sales prices of the same tangible, non-custom software sold by third-party retailers, who have title to the tangible software but do not hold any patent or copyright interests in the software, to unrelated customers in arms-length transactions. For

(...continued)

switch. Pacific Bell's ability to use the information contained in the SSP was an intangible personal property right.". Bold and italics added.

[5] See *Nortel*, *supra*, 191 Cal.App.4th at pp. 1267-68: "The completed SSP [switch-specific software program] is shipped to Pacific Bell on disks, magnetic tapes, or cartridges, also known as 'storage media' . . . The cost of producing the storage media is negligible – $54,604 – and the licensing agreements do not separately state a price for the storage media."; see also *id.* at p. 1276: "Pacific Bell made little use of the ***tangible*** disk containing the program, which was simply copied onto its computers, but it made continuous use of the ***intangible*** information contained on the disk, information that was necessary to run the switch. Pacific Bell's ability to use the information contained in the SSP was an intangible personal property right."] (bold and italics added).

> example, if (i) Company X and Company Y both sell the same non-custom software directly to consumers, (ii) Company X holds patent and copyright interests in the software and sells the software and patent and copyright interests to its customers under TTAs for the lump-sum price of $100, and (iii) Company Y does not hold any patent or copyright interests in the software and sells the same software to its customers for $100, then the amount charged for the software under the TTAs would also be $100 (taxable) . . . .

This hypothetical does not describe transactions that occur in the real world and does not reflect the way software companies conduct business. As a result, it is not a useful guideline to auditors. Unfortunately, the memo relies on this unrealistic hypothetical for illustrating a method of determining the amount eligible for exclusion under a TTA. This example has the following fundamental problems, among others:

(1) Retailers do not hold and transfer title to software, but rather only to tangible storage media;

(2) The hypothetical relies on the incorrect assumption that "[s]software transferred on tangible storage media is tangible personal property . . . ." (Memo, at p. 4.), when, as shown above, software and the right to use software are never tangible personal property; and

(3) To the extent this hypothetical suggests a retailer held or attempted to transfer software without the necessary assignment or license to use the software, it does not consider whether and how the customer has or obtains the license necessary to use the software. In this hypothetical, either (i) the customer has no license to use the software and does not obtain one, in which case it describes pirated software, or (ii) the customer already has obtained a license to use the software, and merely is receiving storage media containing the previously licensed software.

Determining the value of the tangible storage media is a rather simple task, as blank storage media are widely available for sale at retail electronics and office supply outlets. Under the hypothetical quoted above, with respect to sales by Company Y, the price of the tangible personal property would ***not*** be $100 but merely the price of the tangible storage media or even less.[6]

In fact, a customer acquiring title to a copy of computer software stored on tangible storage media without also acquiring the right to use the software (*i.e.*, execute the sequence of instructions) would not be willing to pay any more than the price for which the customer could separately acquire the blank storage media, if even that much.

With respect to the discussion on page 5, at paragraph 2(c), the software development costs are irrelevant. (See §§ 6011(c)(10)(C) and 6012(c)(10)(C).) If the cost of copying the

[6] Indeed, when the tangible storage medium is a mere disk, the value of the storage medium is insignificant. In fact, software intermediate storage disks might qualify for the container exemption of Sec. 6364(b).

software onto the storage media is of any relevance, there is, among other things, a disk duplication industry from which useful information might be obtained.

2. The Memo Imposes Artificial, Impractical, and Legally Unnecessary Audit Burdens on Taxpayers.

The memo instructs field auditors to require in all instances (i) that taxpayers verify such matters as the specific copyright or patent interests that have been transferred, (ii) that taxpayers provide documentation of filings with the United States Copyright and Patent Offices, and (iii) that taxpayers in a chain of distribution verify that they hold copyright and patent interests in software they transfer to end user customers. The memo also advises field auditors to scrutinize the ownership of intellectual property rights that are held in a separate affiliated or subsidiary corporation. The memo presents these requirements as the exclusive means of demonstrating the legal relationships with which the TTA Statutes are concerned. In fact, these instructions ignore the business models and business realities of the software industry and impose legally unnecessary, impractical, and unreasonable audit burdens that are inconsistent with the TTA Statutes and *Nortel*.

As noted above, copyright protection attaches to software as a matter of law when the source code for the software becomes fixed in a tangible medium of expression, i.e., at the time the developer writes the code. There is no requirement that the developer file anything at all with the U.S. Copyright Office. Thus, there should be a presumption that the software in the hands of the developer is subject to a copyright interest for purposes of the TTA. While more steps are necessary to obtain a patent, showing that the software is patented should not be necessary because such would be superfluous as the software already is subject to copyright.

Software developers market their software subject to acceptance by the customer of an “end user license agreement” or “EULA.” Before the customer can install the software on a computer and use it, the customer must accept the on-screen EULA. Acceptance of the EULA gives the customer the right to use the software. With regard to direct sales of software licenses by the developer to customers, there should be no question that the transaction qualifies as a TTA; all the elements of a TTA are present.

Many software developers employ third party “value added resellers” (or “VARs”) and retailers to market their software products to customers. In order for a VAR or retailer to demonstrate entitlement to the TTA exclusion, it should be legally sufficient for the VAR or retailer to produce an invoice from either the software developer or the developer’s authorized reseller in the chain of distribution. Whether the customer acquires the software directly from the developer or a VAR or retailer should not make a difference with regard to whether the transaction qualifies as a TTA. Retailers should not be required to prove that the software packages on their shelves are not pirated.

The memo, at page 4, directs that, in circumstances where intellectual property rights are held in a separate affiliated or subsidiary corporation, an auditor require express written assignments of such intellectual property. This requirement is also legally unnecessary. The very creation of such a corporate structure demonstrates the intent that the retailing subsidiary within the corporate group will have the necessary rights required to license to the end-user customer the right to use the software. Assuming *arguendo* that in some cases there is no express written assignment of the relevant patent or copyright interests, no such express written assignment is legally required to create the licensing rights in the retailing entity because, under the relevant business practices, the retailing entity is intended by the corporate group to possess the licensing rights. The intellectual property subsidiary is not going to sue the retailing subsidiary for infringement.

The specific, exclusive audit substantiation requirements described by the memo are legally unnecessary and impose unreasonable burdens on taxpayers. The alternative substantiation of providing an invoice, as described above, is legally sufficient.

3. The memo misinterprets the TTA Statutes and the unanimous decision in *Nortel.*

Prior to enactment of the TTA Statutes, the Board's staff correctly anticipated that, if enacted, the TTA Statutes would exclude from taxation the licensing of non-custom software. (See State Bd. of Equalization, analysis of Assem. Bill No. 103, as amended Aug. 17, 1993, pp. 3-4.). As the *Nortel* court observed:

> The Board warned the Legislature that the language covering licenses to "use a process" could mean the right to use a computer program; this interpretation would exempt software licensing agreements that limit the buyer to conditional use of the program. This, in turn, would reduce state tax revenues. Despite the Board's concerns, the Legislature enacted the TTA provisions with the language to which the Board objected.

(*Nortel*, *supra*, 191 Cal.App.4th at pp. 1269-70.) The *Nortel* decision confirmed the Board staff's pre-enactment interpretation to the Legislature of the TTA Statutes, namely that software licensing agreements are TTAs and that the right to use software transferred pursuant to a TTA is excludible from taxation. (See generally *Nortel*, *supra*.)

The memo thwarts the proper administration of both the TTA Statutes and the *Nortel* decision by suggesting an unfounded definition of tangible personal property and requiring, in all instances, impractical and unnecessary substantiation requirements for taxpayers. Such an interpretation (1) contradicts the law as it now stands in California, (2) contradicts federal intellectual property law, and (3) attempts to reverse the will of the state legislature, which "enacted the TTA statutes over the Board's objections." (*Nortel*, *supra*, 191 Cal.App.4th at p. 1269.)

4. Conclusion.

We hope you find these comments useful. If you have any questions or would like further information, do not hesitate to contact the author of this letter, Mark Nebergall, who can be reached at (202) 486-3725 or mnebergal@softwarefinance.org.

Respectfully submitted:

California Chamber of Commerce
California Manufacturers & Technology Association
California Taxpayers Association
Council on State Taxation
Silicon Valley Leadership Group
Silicon Valley Tax Directors Group
Software Finance & Tax Executives Council
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cc (Via Email):

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